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The times, they are a-changing

Features

Corporate Tax

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Pete Miller considers the corporate tax proposals in the 2009 Budget.

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Key Points

- Background to the latest corporate tax proposals.
- Fundamental changes to the taxation of dividends received by UK companies.
- Loan relationship anomalies corrected.
- Changes relating to non-cumulative fixed rate preference shares.
- New compliance provisions affecting companies.

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This year's Budget announcements demonstrated some major changes in the way in which the UK's tax system is run. First, a large proportion of the measures were neither new nor a surprise. In terms of preparing material on corporate tax issues, my notes were 90% complete before Mr Darling started speaking. Secondly, the Budget shows just how much Government is now engaging with, and heeding the call of, business. Measures such as the simplification of TCGA 1992, s 171A arose from the Related Companies Simplification Review, a joint HMRC and business group that has met several times to discuss areas where the corporate capital gains system can be improved to everybody's benefit. Similarly, the measures relating to the taxation of foreign dividends have been the subject of wide and lengthy consultation and the new legislation to be enacted this year clearly shows the value of that consultation process. Finally, we also see some measures that start a new phase in HMRC's battle to increase compliance and reduce tax

avoidance. The line is drawn, with provisions that will require companies to nominate a responsible officer, measures to name and shame tax evaders, and more to come. These changes are the subject of this article on the 2009 Budget.

Taxation of foreign profits

This project involves five work streams, the first three of which are of immediate relevance and are discussed in more detail in this article:

- Taxation of dividends.
- Treasury consent.
- Controlled foreign company (CFC) rules.
- World-wide debt cap -- deferred until 1 January 2010 and only applicable to large enterprises.
- The 'unallowable purpose' test -- not mentioned in this year's Budget.

Information on these measures was contained in Budget Note BN05 (www.lexisurl.com/BN05).

Taxation of dividends

The taxation of dividends received by UK companies is fundamentally changing as part of the wider project looking at the taxation of foreign profits. Under the current regime, a dividend received by a UK company from another UK company is exempt from corporation tax. However, dividends received from a non-UK company are taxed, although credit is generally given for the underlying tax suffered by the paying company on its profits before distribution. This mixed treatment of distributions has been challenged as being incompatible with the EC Treaty and the proposed changes follow that challenge. The new rules will apply to distributions received on or after 1 July 2009.

Under the new rules, all distributions received by UK resident companies, except capital distributions, are treated as taxable, unless they are exempt. There are then five 'exempt classes' of distribution which would be expected to cover most distributions received by UK resident companies, whether from other UK companies or from non-UK companies. It is only necessary to fall into one of these classes in order to qualify for exemption. The exempt classes are:

- distributions from controlled companies, which should cover most dividends from subsidiaries (including dividends received by small companies, which were originally intended to be taxable in all cases);
- distributions in respect of non-redeemable ordinary shares, which should cover almost all ordinary dividends;

- distributions from portfolio shareholdings of 10% or less, which should cover most dividends not within the previous two categories;
- distributions that are not designed to reduce UK taxation, which should cover most of the rest; and
- distributions in respect of shares accounted for as liabilities under generally accepted accounting principles; mainly certain redeemable preference shares.

Therefore, the vast majority of distributions received by UK companies will be covered by at least one of these exemptions.

There are, however, exclusions from the general exemptions. Any amounts of interest which are deemed to be distributions will remain taxable, as will distributions where the paying company is able to claim a tax deduction in the country of origin. Finally, there is an overriding targeted anti-avoidance rule (TAAR) which ensures that dividends are taxed either if they are made 'as part of a scheme the main purpose, or one of the main purposes, of which is to obtain a tax advantage' or if the scheme is one of the specific prescribed schemes in the legislation.

While HMRC were required to act because the UK's scheme of taxation of dividends was potentially incompatible with the EC Treaty, the new rules, whereby all dividends are taxable unless they are exempt so long as they do not fall within any of the exceptions to the exemptions, are over-complicated. More importantly, they will introduce greater uncertainty into the system and are therefore likely to increase the possibility of HMRC challenge.

Treasury consents

Certain transactions including shares or securities of non-UK companies required formal consent from the Treasury -- one of the very few provisions within the legislation where the sanction for failure to comply was imprisonment! For transactions involving shares or securities of companies resident within the EU, there was a reporting requirement only.

Under the new proposals, it will only be necessary to make a report of certain large transactions within 14 days of the end of the quarter in which the transaction took place. A reportable transaction will be one whose value exceeds £100 million, which is specified in the legislation, and is not within one of the exclusions. Specified events or transactions are broadly the issue of shares or debentures by a foreign subsidiary or a transfer of shares or debentures of a foreign subsidiary by a company. There are also some minor categories including any event or transaction specified in regulations made by HMRC. Transactions are excluded, however, if they are carried out in the ordinary course of a trade, if all the parties to the transaction are resident in the same territory or if the transaction involves the provision of security to the bankers of a foreign subsidiary. Finally, HMRC can specify further excluded transactions.

Failure to comply with the new reporting requirement may result in a monetary penalty, but the sanction of imprisonment for non-compliance will no longer exist. This new legislation will apply to transactions undertaken on or after 1 July 2009.

This is an important simplification of a rule that was certainly out of date and was arguably never needed -- it was introduced to counter the decision in the *Daily Mail & General Trust plc* case ([1988] STC 787), which the Inland Revenue won in any event.

Controlled foreign companies

Two changes are required to the controlled foreign companies (CFC) regime, which is generally being reviewed. The acceptable distribution policy (ADP) exemption is repealed, as are the rules for certain holding companies qualifying under the exempt activity test. Neither test is required, as most dividends will be tax free anyway. This new regime applies for accounting periods starting on or after 1 July 2009, with special provisions for accounting periods straddling this date.

Corporation tax

HMRC's Budget Note BN06 (on the internet at www.lexisurl.com/2009BN06) provides brief information on loan relationships and connected companies.

Connected party debt

There are two new rules correcting anomalies in the loan relationships legislation as it applies to connected parties.

One of the new rules applies to the late payment of interest between connected companies. Under the current rules, if interest on a loan is not paid by a UK company within 12 months of the end of the accounting period, and the connected recipient company is not chargeable to UK corporation tax on the interest accrued, then an interest deduction is denied until the interest is actually paid (now CTA 2009, s 374). This rule has been challenged as being non-compliant with the EC Treaty and is now abolished for most purposes. A deduction for late paid interest will now only be denied where the creditor is located in a 'non-qualifying territory' (broadly tax havens). The value of consultation in this area was to ensure that there was no unnecessary anti-avoidance provision and the new measure has been kept simple. That said, there is a comment in the Red Book (at A.86) that anti-avoidance legislation will be introduced 'if this relaxation of the rule is abused'.

The new rule will apply to accounting periods starting on or after 1 April 2009. Companies can opt out of this regime for the first accounting period beginning on or after 1 April 2009, and be allowed a tax deduction on a 'paid basis'. This will provide time for companies to rearrange their loans where the current arrangements are based on the paid basis. And interest accrued but not paid, and hence disallowed under the old regime, will still be deductible when paid.

The other change relates to the release of trade debts between companies in the same group. Under the old rules, where a debt was forgiven to another group company, the creditor was not able to claim a tax deduction for the impairment of that debt under the loan relationship rules, as the companies were connected (now CTA 2009, s 354). However, the forgiven debt would come into charge in the debtor company, as a trading profit (CTA 2009, s 94 and, yes, it was TA 1988, s 94, too). This asymmetry is now removed, so that the debtor company is not required to bring the forgiven debt into charge.

This new rule will apply to releases of trade debts on or after Budget Day (22 April 2009) and is a welcome change, particularly in the current economic environment, as previously the forgiveness of intra-group trade debts has required an amount of tax planning to avoid a clearly unfair charge.

Group relief: preference shares

Budget Note BN17 (www.lexisurl.com/2009BN17) explains that a change is proposed in the corporate group rules, to address the problem whereby the use of non-cumulative fixed-rate preference shares might inadvertently de-group companies. This is because these shares may be seen as part of the ordinary share capital of a company, whereas cumulative fixed-rate preference shares are not. The change will address the anomaly by ensuring that noncumulative fixed-rate preference shares are not treated as part of the ordinary share capital where the rate only varies due to the operation of the non-cumulation clause when the

company is in 'severe financial difficulties' or where the fixed-rate dividend cannot be paid for legal reasons (as would be the case in the UK, for example, if the company does not have sufficient distributable reserves).

The change only applies to the test of amounts available to equity holders (TA 1988, Sch 18), not to the more fundamental tests of a group relationship, which are based on holdings of ordinary share capital alone (such as TCGA 1992, s 170 or TA 1988, s 413). HMRC have said that this is because they believe that non-cumulative fixed-rate preference shares are generally only issued with a relatively small denomination in comparison to the rest of the company's share capital, so that they will not have an impact on the appropriate tests of a group (e.g. 75% for group relief or capital gains groups, 51% for the substantial shareholdings exemption).

This new rule applies retroactively to all accounting periods that commenced on or after 1 January 2008. However, companies can elect to retain the existing treatment for shares issued before 18 December 2008. Again, this is helpful in the current economic situation, although it would have been simpler if HMRC had withdrawn their interpretation that non-cumulative preference shares do not carry a fixed rate of dividend.

Reallocation of chargeable gains

Budget Note BN 28 (www.lexisurl.com/2009BN28) explains that where a company in a group makes a disposal, the chargeable gain or allowable loss can be deemed to have accrued to any other company within the group, by means of an election under TCGA 1992, s 171A. This allows gains in one group company to be matched by losses in another, without having to transfer the assets concerned to the same company, first. However, there were restrictions on the availability of the relief, as it didn't apply to transfers within the group, such as to a non-UK resident group member, or to deemed disposals, such as with negligible value claims.

These restrictions are now being removed, and the effect of the election will be to transfer a chargeable gain or allowable loss on disposal to a specified other group company, to allow effective matching of all gains and losses. The change will apply to gains and losses arising on or after the date of Royal Assent to FA 2009.

This is a very welcome change, which arises from the work of the joint working party on related company capital gains. This is a demonstration that these working parties are genuinely useful and have a real impact on the operation of the tax legislation.

Compliance and anti-avoidance

There are a two particularly interesting new compliance provisions, as well as a threat for future action.

Accountability of senior accounting officers

Large companies will have to nominate a senior accounting officer to HMRC (see Budget Note BN62 at www.lexisurl.com/2009BN62). That officer will be formally responsible for ensuring that the accounting systems of the company are 'adequate for the purposes of accurate tax reporting'. The officer will have to take 'reasonable steps' to establish and monitor suitable systems, certify the adequacy of the systems annually and notify inadequacies to the auditors. Both the company and the officer will be liable to penalties for failure to comply with the new rules.

This measure clearly arises out of HMRC's concerns that some tax-related compliance failures stem from inadequate accounting and data capture systems. So this is really trying to get at the ultimate source of the problem and to force companies to establish and maintain adequate systems. While this measure only applies to large companies, it is obviously a measure that could easily be extended to smaller enterprises if HMRC thought it worthwhile to do so.

Naming and shaming tax evaders

In another compliance-related measure (Budget Note BN63 at www.lexisurl.com/2009BN63), HMRC will be seeking the power 'to publish the names and details of individuals and companies who are penalised for deliberate defaults leading to a loss of tax of more than £25,000'. This may seem draconian (although HMRC's Dave Hartnett, for one, has been talking about such a power for some time), but it is important to note that this does not apply to careless defaults, it does not apply to properly disclosed tax planning and it does not apply to 'those who make a full unprompted disclosure or to those who make a full prompted disclosure within the required time'. So this is really only aimed at deliberate tax evaders.

There is also no detail yet as to what 'details' HMRC will be able to publish, given the restrictions in legislation such as the Data Protection Act. But it is intended that details will be published once the penalty becomes final and will be removed after a year.

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General anti-avoidance

Other articles in *Taxation* will no doubt cover the specific anti-avoidance measures announced in this year's Budget by the Chancellor, Mr Darling. But there were a few items in the 'Red Book' (www.lexisurl.com/2009BudRep) that caught my eye. At paragraph 4.53 there is a reference to consulting on 'greater alignment of purpose tests in tax law'. At 5.98, we are told that the hallmarks for disclosure of anti-avoidance schemes are to be extended. And, most interesting of all, at 5.101 we are told that 'HMRC will soon publish a "Spotlight" on tax avoidance with details of a number of avoidance schemes that will be challenged when encountered'.

We do live in interesting -- and changing -- times, don't we?!